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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SEVENTH CIRCUIT AND BRIEF IN SUP-
PORT THEREOF.

BANK J. ALBUS,

Counsel for Petitioner.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,

vs.

Petitioner,

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SEVENTH CIRCUIT.

*To the Honorable the Supreme Court of the United States,
Your Petitioner Respectfully Shows:*

Summary Statement of the Matter Involved

The Petitioner is an Indiana Corporation, with its principal place of business at Marión, Indiana (R. 34). On January 1, 1937 the Petitioner had outstanding 1,124 shares of preferred stock of a par value of \$100.00 per share (R. 34). Roy F. Kelley individually owned 628 shares of the preferred stock, and he held the balance of 496 shares as Trustee for his sister, Mabel K. Ronald (R. 34). During the month of January, 1937, Roy F. Kelley transferred his 628 shares of preferred stock to Mabel K. Ronald, to be held by her as Trustee for the benefit of her daughters, with a

life interest in Berdina Kelley, the wife of Roy F. Kelley (R. 34).

During the month of January, 1937 a special meeting of the Board of Directors of the Petitioner Corporation was held, and a plan of recapitalization was adopted (R. 34). Following this meeting, and on the same date, the shareholders of the Petitioner Corporation held a special meeting and approved the resolution adopted by the Board of Directors (R. 34). This resolution authorized the issuance of income debenture bonds, aggregating the sum of \$250,000, bearing interest at the rate of 8% per annum, and authorized the execution of a trust instrument, setting forth the terms and conditions under which the debenture bonds were to be issued, and setting forth the powers and duties of the Trustees (R. 34 and 35). Under the resolution, the bonds were to be offered by the Trustees in exchange for the outstanding 1,124 shares of preferred stock on the basis of \$102.00 in face value of bonds for each share of preferred stock, and for the purpose of raising additional capital to expand the business of the Petitioner in the field of finance, the Trustees were to offer any and all unissued debenture bonds for sale at face value to the shareholders of the corporation (R. 35).

The trust agreement was entered into, and on July 1, 1937 the holders of the 1,124 shares of preferred stock surrendered their stock to the corporation and received bonds in the face amount of \$114,648. On the same date, Mabel K. Ronald subscribed for \$24,408 of the bonds and Berdina Kelley subscribed for \$10,944 of the bonds. These amounts were carried against Mabel K. Ronald and Berdina Kelley in open accounts on the books of the Petitioner Corporation, and the liability was later satisfied by the credit of dividends received by them on common stock which they owned (R. 35).

During the period from July 1 to December 31, 1937; January 1 to December 31, 1938; and January 1 to December 31, 1939, the Petitioner had outstanding bonds of a face amount of \$150,000, in respect of which \$6,000, \$12,000 and \$12,000 for each period, respectively, were set up on the books of the Petitioner Corporation as accrued interest thereon. The amounts so accrued were paid and were claimed by the Petitioner as deductions in computing its taxable net income for the respective calendar years 1937, 1938 and 1939. These deductions were disallowed by the Respondent on the theory that the payments represented dividends on stock and not interest on indebtedness (R. 36 and R. 8, Par. (b)). The Tax Court of the United States reversed the action taken by the Respondent, and held that the debentures were bonds, with the result that the amounts paid in connection therewith were interest payments which the Petitioner was entitled to deduct in arriving at net income (R. 33, et seq.).

The Commissioner of Internal Revenue appealed the decision of the Tax Court to the Circuit Court of Appeals for the 7th Circuit. That Court reversed the decision of the Tax Court on the basis of its own finding of fact that the issuance of the bonds was not bona fide, which finding is diametrically opposed to the finding of fact made by the Tax Court. The Circuit Court based its conclusion upon its finding of fact that "it was all a matter of accounting hocus-pocus, guided by a little too clever legal planning which eventuated in a rather flimsy scheme to avoid payment of taxes" (R. 59). This finding of fact upon which the entire determination of the Circuit Court rests, is the direct opposite of the finding made by the Tax Court, namely, that the transaction was bona fide, and that as a result thereof, the bondholders became creditors of the Petitioner Corporation (R. 40).

This Court Has Jurisdiction

This Court is expressly given jurisdiction by Section 240 of the Judicial Code, as amended by Act of February 13, 1925 (43 Stat. 938; 28 U. S. C. Sec. 347) to review by certiorari the decision of the Circuit Court of Appeals, "either before or after a judgment or decree by such lower Court." Judgment was entered in this case by the U. S. Circuit Court of Appeals for the 7th Circuit on December 21, 1944 (R. 60).

Statute Involved

Section 23 of the Revenue Act of 1936 (c. 690, Section 23, 49 Stat. 1658); Section 23 of the Revenue Act of 1938 (c. 289, Section 23, 52 Stat. 460); and Section 23 of the Internal Revenue Code (53 Stat. 12, as amended, June 29, 1939, c. 247, Title II, Sections 211 (a), 224, 53 Stat. 867, 880) all provide:

"Section 23. Deductions from gross income.

In computing net income there shall be allowed as deductions:

(b) Interest. All interest paid or accrued within the taxable year on indebtedness." * * * (Balance of Section not applicable).

Questions Presented

The following questions are presented:

(1) Did the U. S. Circuit Court of Appeals for the Seventh Circuit have the right to reverse the decision of the Tax Court on the basis of a fact finding made by the Circuit Court, which finding is diametrically opposed to the finding made by the Tax Court?

(2) Were the debentures issued by the Petitioner on July 1, 1937 bonds, with the result that the payments made

in connection therewith were interest within the provisions of Section 23(b) of the Internal Revenue Code, (53 Stat. 867, 880; Title 26, U. S. C., Section 23 (b)), and identical provisions of the Revenue Acts of 1936 and 1938, or were they stock, with the result that the payments made in connection therewith were dividends within the provisions of Section 115 of the Internal Revenue Code, (53 Stat. 46, as amended by 53 Stat. 873; Title 26 U. S. C., Section 115) and similar provisions of the Revenue Acts of 1936 and 1938?

Reasons Relied Upon for Allowance of the Writ

The decision of the Circuit Court of Appeals for the 7th Circuit is in direct conflict with the decisions of this Court in the cases of *Dobson v. Commissioner of Internal Revenue*, 320 U. S. 489 and *Scottish American Investment Company, Ltd. v. Commissioner of Internal Revenue*, 323 U. S. 119, which decisions held that a Circuit Court of Appeals cannot reverse a decision of the Tax Court on the basis of fact findings contrary to the facts found by the Tax Court (Supreme Court Rule 38, Paragraph 5 (b)).

The decision of the Circuit Court of Appeals for the 7th Circuit is in conflict with the decisions of that Court in the cases of *Geo. F. Fox v. Harrison*, 145 Fed. (2d) 521 and *Superior Coal Company v. Commissioner*, 145 Fed. (2d) 597, in which cases the 7th Circuit Court held that they had no right to reverse a fact finding of the trial court. (Supreme Court Rule 38, Paragraph 5 (b)).

The decision of the Circuit Court of Appeals for the 7th Circuit is in conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of *H. P. Hood & Sons, Inc.*, 114 Fed. (2d) 467, which case involved substantially the same facts found in the case of the Petitioner. (Supreme Court Rule 38, Paragraph 5 (b)).

Wherefore, your^{or} Petitioner prays that a writ of certiorari issue under the seal of this Court, directed to the U. S. Circuit Court of Appeals for the Seventh Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of the said Circuit Court had in the case numbered and entitled on its docket; No. 8426, Commissioner of Internal Revenue, *Petitioner*, v. *The John Kelley Company*, Respondent, to the end that this cause may be reviewed and determined by this Court, as provided for by the Statutes of the United States; and that the judgment herein of said Circuit Court be reversed by this Court, and for such other relief as to this Court may seem proper.

THE JOHN KELLEY COMPANY :

By FRANK J. ALBUS,

Counsel for Petitioner.

Washington, D. C., February, 1945.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 948

THE JOHN KELLEY COMPANY,

Petitioner,

COMMISSIONER OF INTERNAL REVENUE

**BRIEF IN SUPPORT OF PETITION FOR WRIT OF
CERTIORARI**

Opinions of the Courts Below

The opinion of the Tax Court of the United States is reported in 1 T. C. 457, and is printed in full in the record at Pages 33 to 40, inclusive.

The opinion of the Circuit Court of Appeals for the Seventh Circuit is not yet officially reported, but is printed in full in the record at Pages 55 to 59, inclusive.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code (43 Stat. 938, 28 U. S. C. Section 347). The Circuit Court of Appeals has in this case rendered a decision in conflict with the decisions of this Court (Supreme Court Rule 38, (b) (5)).

Judgment was entered in this case by the Circuit Court of Appeals on December 21, 1944 (R. 60).

Statement of the Case

A statement of the case is set forth in the Petition For Writ of Certiorari.

Summary of Argument

The Petitioner is contending that the Circuit Court of Appeals clearly erred in not only ignoring an essential fact found by the Tax Court, but in actually basing its decision on a finding of fact made by it which is diametrically opposed to the finding made by the Tax Court. The Petitioner contends that this action on the part of the Circuit Court of Appeals is in direct conflict with the decisions of this Court in the cases of *Dobson v. Commissioner of Internal Revenue*, 320 U. S. 489, and *Scottish American Investment Company, Ltd. v. Commissioner*, 323 U. S. 119, as well as other Supreme Court cases cited in Footnote (22) in the *Dobson* case.

The Petitioner is further contending that from the standpoint of the merits, the decision of the Tax Court in holding that the instruments involved are bonds is correct; and that the decision of the Circuit Court of Appeals for the 7th Circuit in holding that the instruments are stock is in direct conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of *H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467.

ARGUMENT

POINT 1

The decision of the Circuit Court of Appeals is clearly in conflict with the decisions of this Court in the cases of *Dobson v. Commissioner of Internal Revenue*, 320 U. S. 489, *Scottish American Investment Company, Ltd., v. Commissioner*, 323 U. S. 119, and similar cases cited in footnote (22) in the *Dobson* case.

Under date of December 20, 1943, this Court decided the case of *Dobson v. Commisisoner of Internal Revenue*, 320 U. S. 489, and set forth the circumstances under which a Circuit Court of Appeals may, and may not, reverse a decision of the Tax Court of the United States. In the *Dobson* case, this Court said:

"The judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the Administrative body."

*This Court further said:

"When the Court cannot separate the elements of a decision, so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."

The Circuit Court of Appeals for the 7th Circuit found no "clear-cut mistake of law" in the instant case. It merely refused to recognize a finding of fact made by the Tax Court, namely, that the issuance of the bonds was a bona fide transaction. It made its own finding of fact, namely, that the transaction was "all a matter of accounting hocus-pocus" (R. 59), which finding is the direct opposite of the finding made by the Tax Court. The decision of the Circuit Court of Appeals is based squarely on the aforesaid finding of fact made by it. Even before

the decision by this Court in the Dobson case, it was an established rule of appellate jurisprudence that an appellate court could not disturb the facts found by the trial court, unless there was no evidence to support the finding. There was abundant evidence before the Tax Court to support its finding that the issuance of the bonds was bona fide, and, therefore, the Circuit Court of Appeals for the 7th Circuit had no authority to reverse this finding.

In the Dobson case, this Court further said:

“Where no Statute or Regulation controls, the Tax Court’s selection of the course to be followed is no more reviewable than any other question of fact.”

“The Statute gives no inkling as to the correctness or incorrectness of the Tax Court’s view, and we can find no compelling reason to substitute our judgment.”

The foregoing statements apply with compelling force in the distant case. There is absolutely nothing in the Internal Revenue Code that in any way aids in the solution of the problem as to whether an instrument is a bond or a preferred stock. Neither the word “bond”, nor the word “stock”, is defined in the Internal Revenue Code, and as far as the decision in this case is concerned, the Tax Court could have reached its conclusion without referring to the Internal Revenue Code. Consequently, this is the very type of case which this Court had in mind when it made the above statements in the Dobson case. The principle of the Dobson case has been cited and followed by every Circuit Court of Appeals, and as a matter of fact, it has been followed by the Circuit Court of Appeals for the 7th Circuit in the cases of *George F. Fox v. Harrison*, 145 Fed. (2d) 521, and *Superior Coal Company v. Commissioner*, 145 Fed. (2d) 597.

A case which more clearly establishes error on the part of the Circuit Court of Appeals in the instant case is that of *Scottish American Investment Company, Ltd. v. Commissioner*, 323 U. S. 119, decided by this Court on December 4, 1944, for the reason that the decision of the Tax Court in that case rested squarely on its finding of fact that a certain transaction was bona fide. The sole question in the case was whether an office maintained in the United States by three foreign corporations was a bona fide office or a sham. The Tax Court found as a fact that the office maintained by the taxpayers was a bona fide office, and it, therefore, decided the case in favor of the taxpayers. The Third Circuit reversed the Tax Court on the basis of its own finding of fact that the office maintained in the United States by the taxpayers was a sham. This Court reversed the Third Circuit, and held that that Court had no right to disturb the finding of the Tax Court. During the course of its opinion, this Court said:

"The sole issue revolves about the propriety of, *the inferences and conclusions* drawn from the evidence by the Tax Court." (Italics supplied.)

"The Tax Court has the primary function of finding the facts in tax disputes, weighing the *evidence, and choosing from among conflicting factual inferences and conclusions* those which it considers most reasonable. *The Circuit Court of Appeals has no power to change or add to those findings of fact, or to re-weigh the evidence.*" (Italics supplied.)

"The judicial eye must not in the first instance rove about, searching for evidence to support other conflicting inferences and conclusions which the judges or the litigants may consider more reasonable or desirable."

"We cannot say that it was unreasonable for the Tax Court to conclude that this office was more than a sham, and that it was used for the regular transaction of business."

"We do not decide or infer that the contrary inferences and conclusions urged by the Commissioner are entirely unreasonable or completely unsupported by any probative evidence. We merely hold that such conditions are irrelevant; so long as there is adequate support in the evidence for what the Tax Court has inferred. *It follows that the Tax Court's conclusions in this case cannot be set aside on appellate review.*" (Italics supplied.)

All of the foregoing language applies with compelling force to the action of the Circuit Court of Appeals in reversing the Tax Court in the instant case. The Court held a transaction to be a sham in the face of a contrary fact finding by the Tax Court that it was bona fide. This Court in the *Scottish American Investment Company, Ltd.* case said that this is clearly reversible error. The *Scottish American Investment Company Ltd.* case was decided by this Court seventeen days before the decision of the Circuit Court of Appeals in the instant case was released. The Circuit Court of Appeals did not even mention the *Scottish American Investment Company Ltd.* case, nor did it mention the *Dobson* case, although both of these cases were called to its attention before its opinion was released. The Circuit Court of Appeals cited as its authority for reversing the Tax Court, its own decision in the case of *Commissioner v. Meridian & Thirteenth Realty Company*, 132 Fed. (2d) 182, which was decided on November 5, 1942, long before this Court announced the applicable rule in the *Dobson* case.

The *Scottish American Investment Company Ltd.* case is also of major importance from another angle. In that case, this Court said that the general principle of the *Dobson* case applies with the greatest possible force, where the decision of the Tax Court is such that the particular case will be "of little value as precedent". In this connection, this Court said:

"Moreover, this case exemplifies one type of factual dispute where judicial abstinence should be pronounced. The decision as to the facts in this case, like analogous ones that precede it, is of little value as precedent. The factual pattern is too decisive and too varied from case to case to warrant a great expenditure of appellate court energy on *unravelling conflicting inferences*. The skilled judgment of the Tax Court, which is the basic fact-finding and *inference-making body* should thus be given wide range in such proceedings." (Italics supplied.)

The Circuit Court of Appeals, by its own admission, recognized that the instant case is one falling squarely within the above category. At R. 56 the Circuit Court of Appeals said:

"In deciding cases of this kind, the various provisions of the instrument evidencing the obligation in the light of the surrounding circumstances *in each case* determine whether the relationship created is proprietary or that of debtor-creditor. *Each case stands on its own feet.*" (Italics supplied.)

Regardless of the above statement, the Circuit Court of Appeals took it upon itself to reverse the Tax Court, in direct violation of the admonition set forth by this court in the *Scottish American Investment Company, Ltd.* case. In its opinion at R. 55, the Circuit Court said, "There is no dispute as to the facts," but regardless of this state-

ment, the Circuit Court then proceeded to reverse the key-stone fact found by the Tax Court, namely, that the issuance of the bonds was bona fide and that the holders thereof became creditors of the Petitioner Corporation.

See also the case of *W. G. Choate v. Commissioner*, No. 93, decided by this Court on January 29, 1945 (not yet officially reported), and the many cases cited by this Court in Footnote (22) in the *Dobson* case.

POINT 2

The decision of the Court of Appeals in the instant case is contrary to its own decisions in the cases of *George F. Fox v. Harrison*, 145 Fed. (2d) 521 and *Superior Coal Company v. Commissioner*, 145 Fed. (2d) 597.

The Circuit Court of Appeals for the Seventh Circuit decided the case of *George F. Fox v. Harrison*, 145 Fed. (2d) 521, on November 18, 1944. The trial court found as a fact that the redemption of stock by a corporation was not accomplished at such time and in such manner as to make the redemption essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115 (g) of the Internal Revenue Code. The taxpayer appealed the decision of the Trial Court to the Circuit Court of Appeals for the 7th Circuit. The Circuit Court of Appeals for the 7th Circuit, on the authority of the *Dobson* case, held that it was without power to reverse the decision of the lower court. It will be noted that in the *Fox* case, the Circuit Court of Appeals held on the authority of the *Dobson* case, that it could not reverse the decision of the trial court, which had held that the distribution was not a dividend within the meaning of Section 115 (g) of the Internal Revenue Code. In the instant case, the Tax Court found that the distributions were interest payments

and not dividends within Section 115 of the Internal Revenue Code, yet the Circuit Court of Appeals reversed the conclusion of the Tax Court, and held that the distributions were dividends within the meaning of that Section.

On December 7, 1944 the 7th Circuit decided the case of *Superior Coal Company v. Commissioner of Internal Revenue*, 145 Fed. (2d) 597. In that case, the Tax Court had found as a fact that certain real property had become worthless prior to the taxable year involved. The taxpayer appealed the decision of the Tax Court to the 7th Circuit, and that Court held, on the authority of the *Dobson* case, that it could not disturb the finding of the Tax Court.

Both of the above cases were decided by the Circuit Court of Appeals for the 7th Circuit before it released its decision in the instant case on December 21, 1944. The Circuit Court of Appeals did not mention the aforesaid cases in its opinion in the instant case, and it made no attempt whatever to show in what respects the instant case is distinguishable from the above-mentioned two cases.

POINT 3

On the basis of the merits, the decision of the Tax Court was correct.

The decision of the Circuit Court of Appeals in the instant case is in error when the case is considered solely from the standpoint of the merits of the case, and it is in conflict with the decision of the Circuit Court of Appeals for the First Circuit in the case of *Commissioner of Internal Revenue v. H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467.

The interest on the bonds in the instant case was payable only from income, and the rights of the bondholders were subordinate to the rights of general creditors (R 17).

The Circuit Court leaned heavily upon these provisions in the instrument in reaching its conclusion in the case. But the Tax Court took these matters into consideration in deciding the case in favor of the Petitioner, and it held that in accordance with previous decisions, these provisions in a bond do not necessarily cause an otherwise obvious bond to be classified as a preferred stock (R. 40). These same limitations were present in the case of *Commissioner v. H. P. Hood & Sons, Inc.*, 141 Fed. (2d) 467, decided by the Circuit Court of Appeals for the First Circuit on March 22, 1944. Regardless of the presence of these limitations, the Circuit Court of Appeals for the First Circuit held that the instruments involved were bonds and not stock, and the Court thereupon upheld the decision of the Tax Court, which had decided the issue in favor of the taxpayer. The Circuit Court of Appeals for the First Circuit cited with approval the decision of the Circuit Court of Appeals for the Second Circuit in the case of *O. P. P. Holding Corporation*, 76 Fed. (2d) 11. It is also interesting to note the following statement made by the Circuit Court of Appeals for the First Circuit with respect to the effect of the *Dobson* decision in a case similar to that of the Petitioner:

"Since each case involving the question here presented must largely turn on its special facts, and since the Tax Court applied the correct rule of law, its determination is entitled to the finality indicated by *Dobson v. Helvering*, 320 U. S. — (1943)."

The Circuit Court of Appeals for the 7th Circuit erred in the instant case, in that it predicated its conclusion upon cases which it cites, in which the instruments involved were admittedly in the form of preferred stock, and the taxpayers were attempting to have these preferred stock instruments classified as bonds. Such is not the case here.

The form of the bond appears at R. 17, and speaks for itself. A mere glance at the instrument demonstrates that in form it is a bond and not a preferred stock. The trust indenture under which the bonds were issued appears at R. 19, et seq., and clearly shows that the instruments were in form bonds and not preferred stock. The Petitioner followed out every step normally taken by a corporation in the issuance of corporate bonds. It provided for the bonds by appropriate action of its Board of Directors and of its stockholders. It approved the trust instrument under which the bonds were to be issued. It adopted the wording of the bond which is undeniably in the form of a corporate bond and not a preferred stock. It redeemed its preferred stock, and its preferred stockholders took bonds of a face value of \$102.00 for each share of preferred stock of a par value of \$100.00. It sold bonds of a face value of \$24,408 to Mabel K. Ronald and bonds of a face value of \$10,944 to Berdina Kelley, which were paid for at face value through dividends which Mabel K. Ronald and Berdina Kelley received on common stock which they owned. During the years 1937, 1938 and 1939 all of the issued bonds remained outstanding, and none of them were redeemed or canceled. It is difficult to see what additional steps the Petitioner could, or should have taken in the issuance of the bonds. It followed the procedure which is normally followed by any corporation in the issuance of bonds. Consequently, it cannot be claimed that what it did failed to carry out the intent to create the relationship of debtor-creditor, and the Tax Court found as a fact that this relationship existed as a result of the issuance of the bonds. It is this essential finding of fact by the Tax Court which the Circuit Court of Appeals not only ignored, but took it upon itself to make its own finding of fact diametrically opposed to the finding of fact made by the Tax Court.

Conclusion

It is submitted, therefore, that the Circuit Court of Appeals clearly erred in not sustaining the decision of the Tax Court in the light of the decisions of this Court in the cases of *Dobson v. Commissioner of Internal Revenue*, 320 U. S. 489, and *Scottish American Investment Company, Ltd. v. Commissioner*, 323 U. S. 119, as well as related cases by this Court, and that regardless of the foregoing decisions, the Circuit Court of Appeals erred in deciding the case against the Petitioner from the standpoint of the merits.

Respectfully submitted,

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Washington, D. C., February, 1945.

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